

WASHINGTON STATE INVESTMENT BOARD
Board Meeting
Minutes

April 17, 2003

The Washington State Investment Board met in open public session at 9:35 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: John Charles, Chair
Charlie Kaminski
Glenn Gorton
John Magnuson
George Masten
Patrick McElligott
Mike Murphy
Bob Nakahara
Lee Ann Prielipp, Vice Chair
Debbie Brookman
Jeffrey Hanna

Absent: Senator James West
Representative Helen Sommers
Paul Trause
Jeff Seely

Also Present: Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Sue Hedrick, Executive Assistant
Steve Draper, Senior Investment Officer, Real Estate
Nancy Calkins, Senior Investment Officer, Public Equity
Gary Gallinger, Investment Officer
Beth Vandehey, Internal Auditor
Tom Ruggels, Senior Investment Officer, Private Equity
Bill Kennett, Senior Investment Officer, Fixed Income
Diana Will, Investment Officer

Jeff Lane, Assistant Attorney General
Evelyn Lopez, Assistant Attorney General

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Charles called the meeting to order at 9:35 a.m. and identified members in attendance.

ADOPTION OF MINUTES – March 20, 2003

Mr. McElligott moved to adopt the Board minutes of March 20, 2003. Ms. Prielipp seconded the motion.

The motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

QUARTERLY PERFORMANCE REPORTS

Real Estate - Staff

Steve Draper provided the quarterly report for real estate. He said that returns remain very strong. He has been predicting for some time that investment returns would soften, and he is beginning to see that. He said they have very strong income for the portfolio. Staff does not anticipate negative returns, just lower than the double-digit returns earned over the last ten years. He commented on a few of the larger investments and on Union Square.

Mr. Draper reported the portfolio is outperforming the benchmark over all periods, although they expect the margin to narrow. Over the one-year period, it has a spread of over 600 basis points over NECREIF. He expects it to narrow over the short-term, but over the long-term, expects it to outperform the benchmark by 100 basis points.

Mr. Draper then discussed the composition of the portfolio. He said the office component continues to reduce in size. He believes there are some great sale opportunities, and the Board's partners are actively selling properties. He anticipates that office properties will continue to decline in the short-term. He sees an increase in the other component, which is now broken down to more specifically show this category entails debt investments, timber, land, hotels, miscellaneous investments and agriculture. Residential and industrial will increase over time, while we continue to reduce the office component.

In terms of geographic diversification, the portfolio continues to be focused on the best long-term growth markets, and will remain over-weighted to the West, and to a lesser extent, in the South. He sees many good opportunities occurring outside of the U.S. He expects the portfolio's foreign exposure to exceed the 25 percent guideline in the future.

ADMINISTRATIVE COMMITTEE REPORT

Chair Charles said the Administrative Committee met prior to the Board meeting and received an update from the executive director on budget and staffing. The agency will end the biennium with about \$350,000 out of a \$13.3 million budget. Savings came primarily from vacancies.

The executive director is moving to fill three vacancies on the investment side. The building budget came in almost on target; it ended up being overspent by about \$1,500 out of a more than \$780,000 budget.

The agency's budget for the next biennium is before the Legislature. The Senate budget has a reduction for the WSIB of \$1 million and 4.6 FTEs; the House budget has a reduction of \$108,000 and one FTE.

Chair Charles reported the Committee also heard a report on the Capital Market Assumptions.

He moved that the Board adopt the Capital Market Assumptions report. Mr. Masten seconded.

Mr. Bruebaker said that the Capital Market Assumptions are used for any asset allocation studies that will be done for this year. The assumptions are updated once each year. They serve as the critical building blocks for strategic asset allocation modeling. They attempt to quantify the expected average annual return and risk level over the long run and the correlation between each asset class. The assumptions are not short-term forecasts; rather, they are based on historical asset class returns over various long time periods. He recommended that, before staff does the next asset allocation for the Commingled Trust Fund, the Board should have a belief-challenging workshop to discuss modern portfolio theory, and challenges to the orthodox view.

Mr. Bruebaker said the key change from last year is a reduction of return in each of the asset classes by 50 basis points other than real estate. This is largely due to the low federal funds rate and the effect it has on the base return of cash and fixed income securities. Real estate has been kept at the same level that was approved last year. The capital market assumptions will be used for asset allocation studies to be completed this year.

The motion to adopt the Capital Market Assumptions as provided by staff carried unanimously.

PUBLIC MARKETS COMMITTEE REPORT

Mr. Kaminski said that the Public Markets Committee met on April 1st and had another of the International asset class educational programs presented in roundtable format. Australia and Asia (without Japan) are looking good. State Street Bank discussed trends in securities lending. One of the things revealed during the discussion is that there might be alternatives that might provide a better risk return. Mr. Bruebaker said that State Street was asked to outline the pros and cons of Quality A and Quality D funds, as well as other recommendations on how to increase the return through securities lending, while also better managing the risk relative to it.

Mr. Kaminski said that the managers gave individual reports after the roundtable discussion. They underperformed for the year, but long-term performance is good. [For a more detailed report, please see the minutes of the April 1st Public Markets Committee meeting].

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported on the April 3rd Private Markets Committee meeting.

He moved the Private Market Committee's recommendation that the Board approve an investment of up to \$750 million, plus fees and expenses in Hometown America, LLC, subject to final negotiation of terms and conditions. Ms. Prielipp seconded.

Mr. Masten said that, in 1998, the WSIB began its partnership with Hometown America with a commitment of \$55 million. In September 2000, the Board committed an additional \$200 million to buy out all of the other partners. The company owns just over 15,000 manufactured home sites and has a high cashflow return. Staff and the management team believe there are great opportunities to improve this investment in a short period of time. The turnover of leaseholders is very low. The company does some financing of these homes, and also buys distressed homes at a very high discount and then resells them.

Mr. Magnuson supported the motion. He said that this type of housing generally leads the economy out of a recession. He noted that there are some risks, and the size of the transaction is very large, but it must be so in order to position the company to take advantage of opportunities. He said he is very confident with their property management and operating philosophy.

The motion to invest an additional \$750 million, plus fees and expenses, in Hometown America, LLC, subject to final negotiation of terms and conditions, carried unanimously.

The Board took a five-minute break and resumed at 10:40 a.m.

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear discussed the status of the budget for the 2003-2005 biennium, which is awaiting approval in the House. Representative Helen Sommers restored most of the money that had been cut in the Governor's and Senate's budgets. Mr. Dear said staff is recruiting for the Financial Services Manager position and three investment positions. He said he will not hire a consultant to prepare a strategic technology plan after all. He found two other consultants' reports whose recommendations hadn't been implemented. So, those will be done instead of something new. He described six improvements that will be made by June 30, 2003.

Mr. Dear said it has been very quiet in terms of communications. He mentioned a Dow Jones story about accountability and controls. In terms of Public Disclosure, Mr. Dear said he wrote to all of the private equity general partners to let them know about public disclosure requests for private

equity portfolio performance that the agency has been receiving. Staff has been disclosing fund level performance information since May 1998. The letter was sent because we will now inform all general partners before the WSIB releases any information pertaining to them. He said the letter does not reflect a policy change; it just explains what the agency's routine disclosure policy is, and our intent to provide quarterly updates.

In terms of legislation, Engrossed Substitute Senate Bill 5192 is on the House floor calendar for action. Mr. Dear said the bill now contains only two changes. It adopts an economically targeted investments (ETI) policy consistent with the policy the Board adopted last month. It also changes the terms of non-voting members from three to two years. Mr. Dear said the bill must pass out of the House by 5 pm on April 18 or it dies. If the House passes it, it will go back to the Senate for concurrence with the House amendments.

Treasurer Murphy asked what the bill is trying to fix by shortening the non-voting members' terms. He said he thought the Board should recommend to the Legislature that it drop the bill since he didn't believe there was a point to the bill. The Board has already adopted an ETI policy and he doesn't believe the non-voting members' terms should be changed.

Chair Charles spoke in support of the bill because it reinforces the Board's ETI policy. He said it doesn't change the make-up of the Board with the exception of the non-voting members' terms. He said he thought that having the bill pass would put in statute an additional safeguard.

Ms. Prielipp pointed out that the bill doesn't change the fact that the Board can make reappointments.

Mr. Hanna asked Chair Charles about opinions he had expressed to the chair of the House Financial Institutions and Insurance Committee. Mr. Charles responded that he met with the chair of the committee twice to discuss the operations of the Board. He said he shared with her some of the Board's financial reports and he testified on the bill, indicating the Board had taken a position to oppose the bill as it came out of the Senate because of problems with its provisions on in-state investing. He did testify that shorter terms might allow the Board to recruit other members who wouldn't otherwise want to serve for three years. He repeated Ms. Prielipp's point that the Board has complete control over reappointing members for additional terms.

Mr. Masten argued against taking action on the bill. He said that legislators sponsor bills whether or not lobbyists have a part in it. He said he thought the Board ought to leave the bill alone. It is in a form that he can accept because of the ETI policy.

Daily Priced Investment Options Report

Mr. Bruebaker said that the Savings Pool is up \$15.7 million, and is currently at \$540 million. During this particular quarter, two Guaranteed Investment Contracts (GIC) contracts matured and staff placed an additional two. It currently has a little higher cash balance than staff normally likes to have, \$35 million, or about 6.5 percent of the fund. He said there is one placement that will settle on May 14; some of the funds will come from a maturing contract and the rest will come from cash. After that settlement, cash will be back down to the 5 percent range. The Bond Fund is at \$280.5 million, up \$22.7 million or 8.8 percent from the previous quarter. We have slightly outperformed for the three months ended March 31st, but are down 45 basis points since inception. The short horizon fund is up \$391,000. The mid-horizon is up \$2.5 million, and the long-horizon is up \$1.9 million. Performance for the quarter is down slightly from the benchmark as well as down from inception to-date.

Monthly Investment Reports – Gary Bruebaker

Mr. Bruebaker provided the March monthly performance report. The Commingled Trust Fund (CTF) investment return is up .4 percent for the month. For the month of February, it was down .3 percent. In Private Equity, no transactions closed. Draws and distributions are still down. U.S. Equities are up for the month 1.1 percent, and up for the current quarter to-date 3.66 percent. International Equity is down for the month 1.8 percent. Dresdner outperformed its benchmark with a negative 1.2 percent. Nicholas Applegate was the second best with a negative 1.28 percent. Schroeder was the worst performing manager with a negative 3.92 percent, underperforming the index by 106 basis points. Real Estate was up 3.6 percent for the month.

Total Assets Under Management are down \$96.3 million. The Labor and Industries fund is down \$151 million because of cash flows. The Commingled Retirement Fund is up \$8.3 million. We are within our long-term allocation policy ranges for all of the asset classes. For the month of March, all domestic indexes were up, all international indexes were down.

OTHER ITEMS

Chair Charles read a letter of resignation from Ms. Prielipp, which said that she will be retiring from active service as a teacher on April 30, 2003. Since her retirement precludes her from continuing to serve on the Washington State Investment Board, she will end her term as a board member on that date as well. Mr. Charles read a letter of thanks and congratulations to Ms. Prielipp, and presented her with a gift on behalf of the Board.

ASSISTANT ATTORNEY GENERAL'S REPORT – EXECUTIVE SESSION

Chair Charles said the Board would go into executive session. The purpose of the executive session was to discuss with legal counsel certain litigation to which the Board is a party, and certain potential litigation to which the Board is likely to become a party.

He said that public knowledge of this discussion was likely to result in adverse legal consequences to the Board, and he expected the executive session to last at least 15 minutes. At the end of the executive session, the Board would resume its open session. The Board would or would not then take action in open session upon matters discussed in the executive session. The Board then planned to adjourn its meeting.

[The open session concluded at 11:45 a.m. and the executive session convened immediately thereafter. The executive session concluded at 12:31 p.m. and the open public session reconvened immediately thereafter.]

Ms. Prielipp moved that the Board authorize the Attorney General to take legal action if the conditions described by the Attorney General are met. Mr. McElligott seconded. Mr. Masten called for a roll call vote.

Ms. Brookman voted aye, Mr. Masten voted aye, Mr. McElligott voted aye, Treasurer Murphy voted no, Ms. Prielipp voted aye, Mr. Charles voted aye, and Mr. Gorton voted aye. The motion was approved.

There being no further business to come before the Board, the meeting adjourned at 12:33 p.m.

John Charles
Chair

ATTEST

Joseph A. Dear
Executive Director